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# The Y2000 and the banking sector

A report prepared by the Reserve Bank of New Zealand

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## Key points

- The banking sector in New Zealand is working well to ensure its systems are Year 2000 compliant.
- The Reserve Bank's view is that banks in New Zealand are not vulnerable to any likely international effects of the Y2000 problem.
- The Reserve Bank is well advanced in ensuring its own systems are Y2000 compliant.
- Substantial reserves of bank notes will be built up to meet potential additional demand for cash in late 1999.
- The Reserve Bank will ensure that banks have the necessary liquidity to obtain the cash that they need.
- Commercial disruption caused by the Y2000 problem is not a risk to the banking sector, as banks in New Zealand are well capitalised and have low levels of non-performing loans.
- Depositors' savings are safe because banks have normal back-up facilities for their records, as well as additional contingencies for Y2000.
- Even if there is a "run" on banks, this will not put banks in New Zealand at risk, as banks here are solvent and the Reserve Bank will ensure adequate liquidity.
- As the new millennium begins, the banking sector will continue to be sound.

The following note outlines the implications of the Y2000 problem for the banking sector. It explains what the banking industry has done to address the problem and what the Reserve Bank is doing to ensure that the millennium date passes with a minimum of disruption.

## The banking industry's response

Banks registered in New Zealand have been aware of the Y2000 problem, and its potential seriousness, for some time. Since 1996, and in some cases earlier, banks have been putting in place plans to ensure that their systems will be 'compliant'. The banks have very strong financial and reputational incentives to deal with the problem, and their Y2000 programmes have been properly resourced and supported by their management at the highest level.

The prime responsibility for solving Y2000 problems rests with individual banks and operators of payment switches<sup>1</sup>. However, the banking sector as a whole also has a common

interest in the issue. Banks need to know that their domestic bank counterparties will also be compliant and that payment switches, which effect transfers between banks, will also work. A working group of the Bankers' Association Payments System Committee was set up at the beginning of 1997 to deal with industry-wide aspects of the issue. The objectives of the working group include:

- addressing problems with common suppliers that can not be resolved at an individual bank level;
- monitoring the Y2000 status of member banks; and
- ensuring that systemic risk issues are taken into account.

The Reserve Bank has been a member of the working group since June 1997.

Remedial work and testing of individual banks and payment switches have gone well. All of the switches and most of

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<sup>1</sup> "Payment switches" process payment instructions, and direct relevant debits and credits to banks. Some are operated by the RBNZ, and others by the banks themselves.

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the banks had completed this process by the end of 1998 and the remainder are due to finish in the first quarter of 1999. In addition, it was decided that an industry-wide test was required to check whether all individually tested systems would run as a complete system. This process began in the second half of 1998 and is scheduled for completion in March 1999. This has been a complex task that has required a high degree of co-operation and commitment from all of the parties. The tests, to date, have been successful and have been completed on schedule.

While the banks will still be working on non-critical business systems during the rest of this year, essentially the banking system is already close to being Y2000 ready. Of course, there can be no absolute assurance that there will not be problems on the day. No testing programme can provide certainty beforehand. However, in the Reserve Bank's view, there is no fundamental risk to the soundness of the banking and payment systems. If faults do arise, it is likely that many can be fixed without customers even knowing that there have been problems, while others might cause relatively short-term inconvenience.

There are several factors that are likely to reduce the impact of any failure, these being:

- the date of the event is known;
- key personnel will be available;
- contingency plans will be in place; and
- public holidays will provide a breathing space for fixing any problems.

As well, failures occur in computer systems in the banking sector from time to time, so in that sense Y2000 problems are not unique, and banks have experience in working around them in ways that do not disrupt customer services.

## International implications

The Reserve Bank does not believe that Y2000 problems in the international financial system will have serious implications for the New Zealand banking system. For the most part, New Zealand banks deal with banks in countries that are making good progress in addressing the issue. We do not expect widespread and damaging failures in those coun-

tries. Banks will, as a matter of sound commercial practice, be assessing the Y2000 status of their counterparties. In addition, banks will not be allowed into international transaction messaging services unless they have passed an audit of their Y2000 status. This will reduce the probability of failed transactions and the disruptions these would cause.

Again there can be no absolute guarantees, but any disruptions which do occur, should be manageable.

## The Reserve Bank's response

The Reserve Bank's response to the Y2000 problem has been as follows.

- 1 As a financial institution, the Reserve Bank has been working to ensure that its own systems are Y2000 ready. This process began in December 1996. A Year 2000 team has been established, which has identified all systems in the Reserve Bank that might be affected. The Reserve Bank expects to have all its internal systems replaced, or repaired and tested, by 30 June 1999. From the first quarter of 1999, we intend to go back through all our systems and review them again to make sure that nothing has been overlooked. An additional test of systems will also be undertaken using a replica of the Bank's computer network, which will be running in Y2000 mode. Contingency plans will be developed in cases where, despite our best efforts, we cannot be certain that we will be able to repair or replace an existing system before the new millennium. Reports on this programme are sent to senior management each week and to the Board of the Reserve Bank each month. Our Y2000 programme is also subject to scrutiny by our external auditors.
- 2 The Reserve Bank has been monitoring the status of Y2000 compliance within the banking system through its attendance at the NZBA Y2000 Working Group and in its regular consultation with banks.
- 3 The Reserve Bank has taken steps to ensure that bank note stocks will be sufficient to meet any likely additional demand if people wish to hold more notes over the millennium date. When the new polymer bank notes

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are introduced this year, we will hold the old paper notes in stock, rather than destroying them. At the end of 1999 total cash in circulation, and in reserve, will be approximately \$6.5 billion compared with the normal end-of-year aggregate of \$4 billion. Put another way, *in addition to the normal value of notes on issue*, we will have in reserve notes to the value of more than \$1,000 for every man, woman, and child in the country. Compared with most other central banks, our reserves will be significantly greater, in part because of the happy coincidence that we are moving to polymer bank notes this year.

- 4 The Reserve Bank will conduct liquidity management operations to accommodate any additional demand for notes. In other words, the Reserve Bank will lend banks whatever is required to ensure that they can continue to conduct business as usual over the Y2000 period. Thus temporary conditions in the cash market should not materially affect other interest rates and banks will not have to constrain their lending because they are worried about major cash withdrawals.
- 5 Now that the process of remedial work and testing is nearing completion, the Reserve Bank will also be working, in association with the industry, to ensure that the public is properly informed about the industry's Y2000 readiness and to ensure that appropriate contingency plans are in place.

## Public concerns

There has been speculation that near the end of 1999 people will withdraw substantial amounts of their savings from the banking system, with three concerns being cited as possible reasons. These are:

- 1 People may be nervous that the ATM network, or the EFT-POS network, might be temporarily unavailable in the New Year. In response people may wish to withdraw additional cash beforehand to tide them over. Such a moderate additional demand for cash is quite likely. Meeting that requirement will not be a problem because, as noted above, the Reserve Bank will be carrying substantially increased reserves of cash.

- 2 Depositors may also fear that their bank might get into difficulties because their bank's commercial clients have their own Y2000 problems and might be unable to repay their loans. These fears are unfounded. The Y2000 problem will not pose a material risk to the soundness of the banking system. The major retail deposit-taking banks (or their parents in the case of branches) are well placed to meet any such adverse events. They are well capitalised, and have low levels of non-performing loans.

Moreover, credit losses related to Y2000 problems are likely to be relatively low. The major banks have a substantial portion of their total loan portfolios in mortgages and personal loans, which are not directly affected by Y2000 problems. We believe that most large companies are adequately addressing the issue and that, as a result, there will not be major loan loss problems. Small businesses, in the main, are not heavily dependent on computers and should be able to work around problems using manual solutions. There may be some problems in the medium size business area, but banks are already addressing this by factoring Y2000 preparedness into their credit assessments. This will put pressure on businesses that are not doing enough, and, if progress is not satisfactory, it gives banks the opportunity to reduce their exposure before the event. In the event that a business cannot service its debts because of inadequate preparations for Y2000, the banks will generally have security that will reduce or eliminate credit losses.

- 3 The most 'alarmist' reason why people might wish to withdraw funds from banks is a concern that records of bank deposits may be lost over the millennium date, and that banks will, as a consequence, be unable to repay deposits. The Reserve Bank is confident that this will not happen. Depositors' savings are safe because banks will have the normal multiple backups of customer account records, as well as additional contingencies for Y2000.

Also, if a branch, or even a bank, temporarily runs short of bank notes, due to distribution problems, bank cheques can provide customers with tangible evidence of their claim on their bank without risk of theft or loss.

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In general terms, depositors only have an incentive to withdraw savings from banks if they are concerned about their solvency (the quality of banks' assets) or liquidity (the ability of banks to raise cash). In this context neither scenario makes sense. As described above, Y2000 does not pose a significant threat to the overall quality of the assets of New Zealand banks and the Reserve Bank will ensure solvent banks remain liquid. Therefore, even if significant numbers of depositors wish to withdraw funds around the end of the year, there are absolutely no grounds to believe the Y2000 date change would threaten the viability of banks operating in New Zealand.

Thus, there is no reason for people to withdraw their savings from banks in response to Y2000 concerns. To do so

would be unnecessary and foolish, as it would expose people to the risk of loss or theft, as well as being costly (due to lost interest) and inconvenient. This is a concern to the Reserve Bank and the banking industry, and we will be working with the banks to ensure that any worries that members of the public may have about 'losing their money' are put to rest.

The Y2000 problem is potentially serious and should not be under-estimated. However, in the banking sector at least, appropriate steps have been, and are being, taken. The public can be assured that, come the first few days of the new millennium, the banking system will continue to be something that they can rely on.